The Federal Report

California Public Employees' Retirement System

The Month in Washington: August, 2008

With the Congress in recess, preparation for the party conventions provided some energy in an otherwise quiet capital city. With Congress gone, regulation and investigation took their customary place as the area where news and policy continues to germinate. The Democrats picked a Washington veteran as their Vice Presidential choice, while the Republicans chose a first-term governor from Alaska. Sponsors of 403(b) plans continued to react to the new level of formality asked of them by the IRS and international accountants continued to tighten nuts and bolts on the harmonization plan.

Issues and Events

Conditions Slow Speculation Bill Discussion

Declining prices and political stalemate appear to have silenced the previously fervid calls to restrain speculators rampaging through the financial markets and driving up costs for regular people. As the commodity markets give back a fair measure of their recent steep increase, public outcry seems to have diminished. The last Senate measure discussed before recess for the summer concerned legislation (S.3268) intended to limit “excessive” speculation. The bill aims to divide “non-legitimate” speculators from “legitimate” ones, such as airlines buying futures contracts for fuel or food processors locking in prices for agricultural products.

A further complication for would-be reformers comes from the political corner. The debate on speculators quickly became a forum to discuss energy in general, with many members (chiefly, but not entirely Republicans) asserting that the answer to high energy prices was more supply. To that end, the Senate deadlocked over the GOP’s demand to have a vote on expanding allowable offshore drilling areas and frustrated members went home.

However, House Speaker Nancy Pelosi (D-CA) has recently said she is flexible on the issue, meaning that any Senate provision on drilling could be considered on the House side as well. And, with the minority party mollified, the complete package, including the anti-speculator provisions, could move forward.

Pension advocates have been concerned over consideration of usurping control of investment discretion from the fiduciaries whose duty it is to see to the well-being of the fund and its participants. A measure to ban pension investments in commodities or commodity indexes could still be considered if the larger package on energy springs back to life.

403(b) Clarifications Released

Regulations proposed by the Internal Revenue Service (IRS) included various requirements on 403(b) sponsors, chiefly adding 403(b)'s to the distribution restrictions on other plans and compelling these plans to have plan documents and a distribution formula in place for the usual conditions (based on years in the plan, attaining a certain age, or an event such as severance). These regulations also allow 403(b) plans to be terminated.

The rules, as they often do, generated a fair amount of panic. A recent symposium on retirement issues included a substantial discussion of the dust-up from the regulations. Richard Turner, Vice President and Deputy General Counsel, AIG Retirement, noted that the new need to have documents does not mean they must be submitted to the IRS, which has posted model language for public school districts. Smaller sponsors were also under the mistaken impression that they needed to adopt the *entire* model language. An additional cause for concern came from sponsors who believed that the new rules created additional fiduciary obligations upon them, which Turner said was not the case. Although the new Federal requirements compelling 403(b) plans to operate in a more formal, documented manner does not create additional burdens, plans remain under their State laws governing investment and trustee behavior.

Perhaps more disturbing, Turner said that the new regulations seemed to be pushing some sponsors to close their plans – now allowed under the same regulations – and move to 401(k) or 457 plans. He noted that such a move would not solve many problems, as the new regulations must be applied prior to closing a plan and that 401(k) and 457 plans have as many, if not more, regulations than those 403(b) sponsors might flee; in fact, most of the new rules for 403(b) plans are derived from those already in use for other deferred comp systems.

GAO Finds Risks of "Significant Misuse of Funds" in Medicare D Plans

The Center for Medicare and Medicaid Services (CMS) does not have sufficiently forceful oversight procedures in place to check the Medicare Part D drug program for fraud and abuse, according to the Government Accountability Office (GAO).

The GAO looked at five plans to review protections that all plans should have by law. All had written protocols for detecting fraud but only two had trained their workers to understand the law and the most widely used fraudulent practices. For its part, CMS does not use on-site inspections but instead relies upon self-assessment by the plans being policed. Acting CMS Administrator Kerry Weems noted that a cap of $720 million imposed by Congress in 2003 for audits has "seriously degraded" the agency's ability to oversee the $40 billion program.

Service Providers Should be Under Fiduciary Net …

The Government Accountability Office (GAO) repeated its recommendation that firms servicing 401(k) accounts should be placed under ERISA to require disclosure and the Department of Labor (DoL) should be allowed to recover losses caused by service providers even if they are not officially classified as fiduciaries. The GAO report says in part: “If finalized, compliance with this rule could eliminate some of the confusion surrounding the sharing of fiduciary duties between sponsors and their service providers and help sponsors provide better oversight of plan services.”

The main thrust of the proposal appears to concern 401(k) plans and the investment of funds among the provider’s menu of options, although the rule could provide guidance for 457 plans as well. The nebulous state of providers as involved in fiduciary matters but in some cases not completely considered to be fiduciaries remains problematic for them and plan sponsors. GAO found sponsors often assumed they had effectively transferred fiduciary obligations to their vendors, but this act was news to the vendors. Large numbers of sponsors surveyed by GAO used an investment committee and an outside advisor to make investment decisions, with the committee having the final say. The government agency stressed that oversight of vendors remains a fiduciary responsibility of the sponsor and expressed some concern over funds where the vendor is the main source of overseeing its own performance. That situation also invites the vendor steering investments into their own family of funds, where profits are generally higher. The GAO endorsed plans having a formal, written investment policy but warned that there could be liability trouble if the plan does not follow that policy.

The GAO also reviewed DoL procedures for keeping a rein on service providers. The Department collects data from plans, maintains an educational effort aimed at informing sponsors of their responsibilities, and looks into allegations of wrong-doing. More required disclosure, both from plan to participant and from vendor to plan, are in the works at DoL, such as the recently completed new regulations on fee disclosure and its components.

GAO said again that Congress should provide clarity on ERISA obligations for service providers. Such a move would also ease regulation from the DoL’s perspective, according to GAO.

… And DoL Proposes Model Disclosure for Advisors

The Pension Protection Act (PPA) specified that investment advisors could satisfy some of the law’s requirements by adopting either a “level-fee” compensation system or through the use of an “unbiased” computer model. The provision came in response to perceptions of excessive fees and potential conflicts of interest among advisors, in the 401(k) and IRA service sector. The Department of Labor (DoL) released proposals in late August.

The DoL guidelines define what constitutes “advice” and mandates that the advisor know basic information about the participant that relates to the investment stance they should take. The advisor must fully disclose fees and linkages between the advice and other groups or people that might constitute a conflict-of-interests. Any investment advice will also be run past a plan fiduciary. Brad Campbell, Assistant Secretary of Labor for Employee Benefits Security Administration, said "One of the most important elements of this proposal is we are facilitating one-on-one investment advice." The DoL proposal also lays out various requirements for a good-faith effort at an "unbiased" computer program to provide advice.

There follows a 45 day comment period about the rules, which will then become effective.

Harmonized Accounting Draft Due Later This Year

Efforts to harmonize global accounting standards and thus make life easier, at least in the long term, for institutional and individual investors, will advance in the fall as the accounting industry's governing body and the Securities and Exchange Commission (SEC) circulate discussion drafts of new rules.

Currently, much of the world uses the International Financial Reporting Standards (IFRS) while the U.S. uses Generally Accepted Accounting Principles (GAAP). A unified standard would put every company on balance sheets prepared and read the same way.

As the month ended, the SEC released a draft rule that advances a timetable for considering, and possibly adopting, the international standard. Although still being analyzed by interested parties, the SEC rule appears to advance a far more deliberate process for considering and ultimately transitioning to the international standard than had been expected. The SEC action appears to be in response to Congressional leaders and other investors who were concerned about the speed at which these decisions were being advanced. As a result of the proposed rule, it's likely to be years before final decisions are made in this important arena.

There has been little public discussion of how adoption of IFRS may affect the rules and procedures promulgated by the Government Accounting Standards Board (GASB), the public accounting counterpart to FASB.

Related National and Industry News

Feds May Force Investment Banks to Hold Higher Reserves

The price for the extension of the Federal safety net to investment banks is likely to include higher capital standards.

The recent emergency sale of troubled Bear Stearns engineered by the Federal Reserve and made possible with its loans continues to work through the political and regulatory system. The investment banks that often drive market activity (and prices) could be forced to significantly up their reserves, perhaps even to the level of the commercial banks traditionally under the aegis of the Fed. As *Reuters* put it, "That could be tough for Wall Street to swallow, because it could translate to lower profits and lower stock prices." Less investment capital could also increase the duration of the economic downturn.

Some opinion, although still short of consensus, holds that financial institutions backed by the taxpayer must have more reserves than those which fly or fail based on the market alone, where the burden of failure falls on investors and creditors. “The taxpayer has a right to a voice in what he’s going to be insuring in the future,” said Roy Smith, a professor at New York University and a former investment banker. Regulators are reportedly seeking the right method to weigh risk and assign reserve requirements for investment banks. The prod for the new system comes as securities previously thought safe, like mortgages, suddenly became otherwise, raising questions about how much should be reserved for obligations previously considered of little risk. Commercial banks maintain reserves equal to about 10% of their adjusted assets compared to equity, while investment banks can be up to three times more leveraged or more.

At the moment, no one is proposing that investment banks exactly mirror the reserve practices of commercial banks. However, industry experts suggest that investment banks will start shoring up reserves in anticipation of being told to do so. Market conditions had already begun the process of pulling back and digging in, and the new inspiration to do so from potential regulation only heightens the effect.

Washington Post Calls for Freddie, Fannie Bailout

The *Washington Post* ran a series of articles detailing the failure of Fannie Mae and Freddie Mac to control risk in their portfolios, and how their mission to boost affordable housing availability brought them further out in the sea of subprime mortgages. It concluded the series with an editorial calling for Treasury Secretary Hank Paulson to guarantee the securities of the two organizations and merge them into the government.

Fannie and Freddie are Government Sponsored Enterprises (GSE’s), creations of the government but owned by private shareholders. However, the market has always seen GSE’s as implicitly backed by the government. The *Post* calls for making the implicit explicit and turning out both the shareholders and management of the two troubled concerns.

Paulson has contended that the more oblique promise that the government would be supportive of the two GSE’s would be enough for the market to stabilize and for Fannie and Freddie to stop hemorrhaging capital. Instead, the death march has continued, with the two GSE’s shedding capital, shareholder value, and their low borrowing rates as little improvement seems to be near for the $390 billion in subprime mortgages they hold as assets against an estimated $6 trillion in other mortgages. Created to facilitate home ownership, if Fannie and Freddie cannot borrow cheaply and pass that savings on to prospective home buyers, then it cannot perform its mission, argues the *Post* on behalf of many who share that view.

Many insist that “Dr. Market Discipline” has the medicine that would be the best cure for this mess, and that the two entities, owned by private shareholders, should be allowed to fail. What would happen to the half of all U.S. mortgages owned in some way by the two giants is unclear, or how the market would react going forward. Those represented by the *Post* argue that taking over the GSE’s now would stop the bleeding and limit the financial liability of taxpayers, already estimated at $25 billion, and rehabbing them under the shelter of government control with an eye toward dividing the operation into public and private spheres.

The Congress returns from its summer recess following the Labor Day holiday and the Republican convention on September 8, 2008.